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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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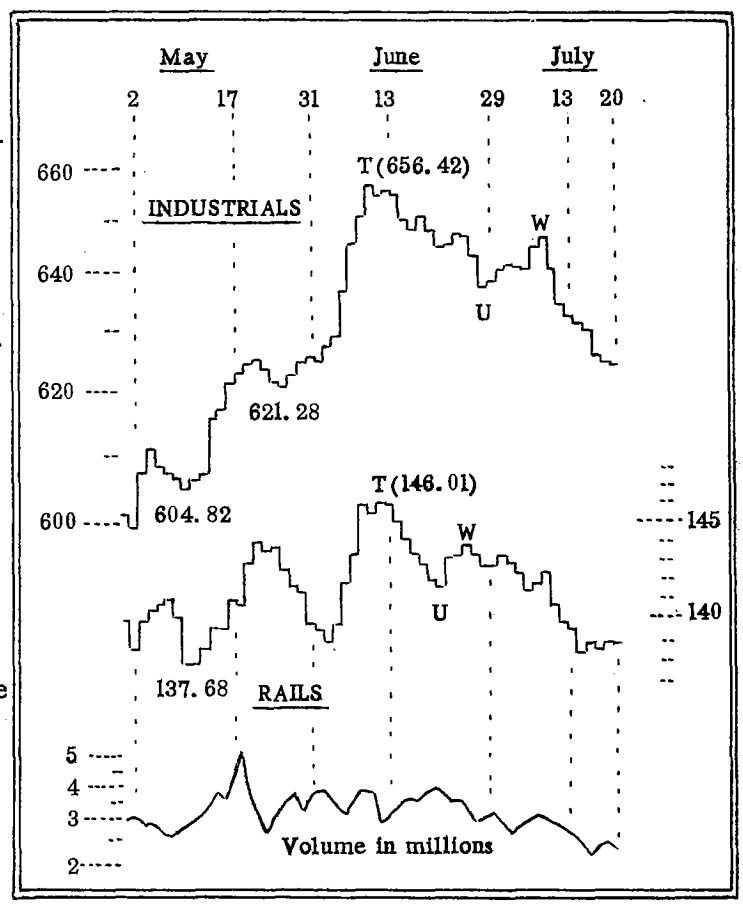
CURRENT SITUATION. Market experts are saying that adverse foreign news has caused the decline since T. But for four months Rails have stubbornly refused to confirm the Industrial advance, and it is doubtful whether that lack of confirmation can be blamed on the recent activities of the Cubans, the Russians or the Congo natives. Moreover, in view of all the international "saber rattling", one wonders why it has been the electronic stocks which have spearheaded the general decline.

Industrial production may run at "white heat", but if goods are not shipped there will be no profits. The Rails, by refusing to confirm the Industrial advance, have been saying that regardless of the high rate of factory production, merchandise was not going to move out as fast as it was being produced.

For many months hopes and wishes have dominated the thinking of leading market experts and business leaders. We were told that the nation was "living off inventories" and that in due time stockpiles would have to be built up again. In fact, a forthcoming inventory build-up was one of the forces which was supposed to spark a new boom later this year. Then along came the latest Government figures which showed that inventories were not only continuing to increase but that the rate of increase was actually accelerating (May inventories increased 700 million dollars against 300 million in April).

Obviously, owners of Rail stocks saw the picture long before the Government economists did, and in refusing to better their 146.56 secondary high, Rails have belied the hopes of the optimists. We are currently witnessing the inevitable slow-down in production which must take place when inventories accumulate faster than goods can be sold. Production of appliances, autos, trucks, lumber, paperboard and steel is now sagging as the glut in unsold goods continues.



Many investors are anxiously scrutinizing the political situation, and they are calculating the effect of a possible Democratic spending spree in the fall. Others are saying that a Rockefeller-type defence program would go a long way toward rejuvenating the economy. The inflationists are waiting for the Federal Reserve to lower stock margins or perhaps to reduce the discount rate another notch (the latter despite last week's 69 million dollar loss of gold). But in the long run the only factors which can be counted on to influence stock behavior are forthcoming increases or decreases in corporate profits.

It is also worth noting that mere volume of sales will not insure rising profits. Business may expand while other factors such as tight money, labor costs, tariffs, national and international competition, crop failures, material costs, etc., can actually erode profits.

PRICE MOVEMENTS. The Industrial advance from May 3 to June 9 (T - see chart) was steep and violent. The entire advance consumed 27 trading days. The decline from T has been gradual and sloping. It took 25 trading days to retrace a little better than 50% of the entire preceding advance. This dragging decline following a sharp rally is typical of bear market action. While it has not been apparent in all the Industrial action since the July, 1959, top, it has been fairly characteristic of all the Rail action since then.

Volume on the decline has been dull, which is suggestive of discouraged investors' accepting lower bids rather than any pressure of liquidation. Often during a bear market volume will hold low (remember January's action) until important preceding points are violated, whereupon trading will suddenly expand. For this reason it is possible that we will not see any heavy downside volume until the 599.10 Industrial level is violated. It is also well to remember that dullness in a bull market often precedes rallies, but in a bear market dullness is usually the prelude to a decline.

By violating point U Industrials have now formed a large descending zig-zag; this together with the series of downward zig-zags in Rails suggests that the secondary trend has turned down. Proof of this will come if and when both Averages violate their bear market lows, Rails at 137.68, Industrials at 599.10. If those lows are violated it will mean that the third leg of the bear market is underway.

In a falling market previous decline points (not previous rally peaks) become points of resistence. Conversely, in an advancing market preceding rally peaks (not previous decline points) become resistence levels. Two decline points now stand between the current Industrial level and the bear market low, 621.28 and 604.82 (both points are marked on the chart).

When critical downside points are approached it is not unusual for the Averages to become extremely erratic. Often violent upside movements will occur (giving the appearance of the Averages' fighting or resisting the penetration). The action of the market in February, 1960 (prior to the bear signal) was a good example of this. For this reason, if the two Averages again approach the bear market lows it would not be surprising to see another brief period of wild, "whipsawing" movements.

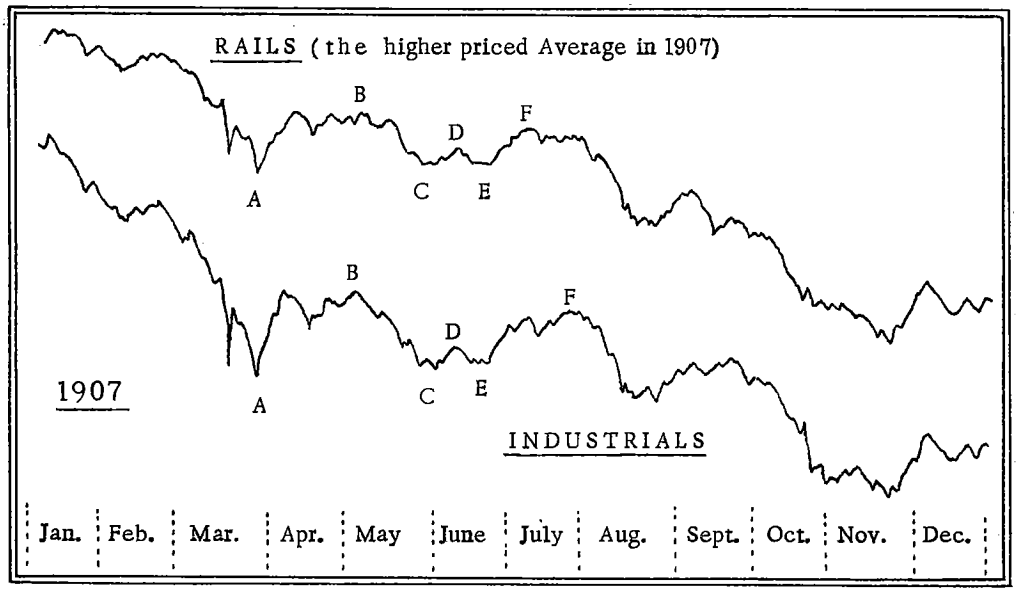
CONCLUSION. The primary trend is bearish. The secondary trend is probably bearish. The quick-changing minor trend is also down. As of this writing Industrials have fallen eight days in a row, suggesting that at least a minor rally is overdue.

COMPARISONS. A study of the history of the price movement suggests that the more times an important point has been "tested" (approached but not violated), the more drastic the resultant move if and when that point is penetrated. The accompanying chart traces the pattern of the Averages throughout the year 1907. Because of the similarities in the price movement then and now, I feel that the 1907 period is well worth studying.

Following a sharp decline which began in late 1906, both Averages touched lows in March, 1907 (A on chart). From there a rally extended into early May (B). In mid-May the two Averages declined to test the previous March lows (C), then rallied to point D. From D another decline (to E) served to retest the earlier C levels. When the C levels again held, the advance to F was sparked.

Observers in July, 1907, must have considered the A-C-E area almost impenetrable. But a great bear market was in progress, and the primary trend continued down. In October the "triple base" was shattered, and the force of the penetration was breath-taking.

In a period of a few months Industrials lost 30% of their total value.



The 1907 example was not unique. Only five years earlier, in 1902, a double bottom was broken, following which one of the most drastic declines in record set in. Because of these and other precedents, it seems to me that if the current bear market lows are violated probabilities again favor some drastic downside action.

INVESTMENT PROCEDURE. The most important and perhaps most difficult Dow Theory procedure to follow is that of investing (or selling) in harmony with the great primary trend of the market. This procedure may sound easy -- it is not. I have listed a few of the difficulties which arise in connection with this primary trend principle: (1) The direction of the primary trend is not always certain; there have been extended periods during which even the most knowledgeable market students were in doubt as to the trend. (2) Secondary reactions can be mistaken for primary reversals -- herein lies one of the greatest hazards for the long-term holder. (3) The majority of investors (this writer included) are subject in varying degrees to greed, fear and pride of opinion. Greed makes us buy or sit with our stocks when we should be out of the market. Fear causes us to dump our holdings when we should be buying. Pride of opinion causes us to fight the trend when mounting evidence suggests that we are wrong.

The book, "Making the Dow Theory Work" (see last week's Special Notice) contains some excellent advice in regard to investment procedure. For instance (page 31), when a new bull market was in the offing, 100% of available funds were invested. During secondary reactions half the funds were sold in the hopes of reinvesting at lower levels. This method served the book's authors well and is about in keeping with my personal notions. Yet in the final analysis, each investor must examine his own emotional make-up and adjust his investment policy to meet his own needs. In the market greed usually rules at the top, fear rules at the bottom and patience rules -- never. I find that in my own trading I will not hesitate to invest 100% of my funds in a bull market whereas in a bear market I tend to fret with a short position which runs much more than 10% of my available capital. Nevertheless, I have known men who were happier on the short side than the long.

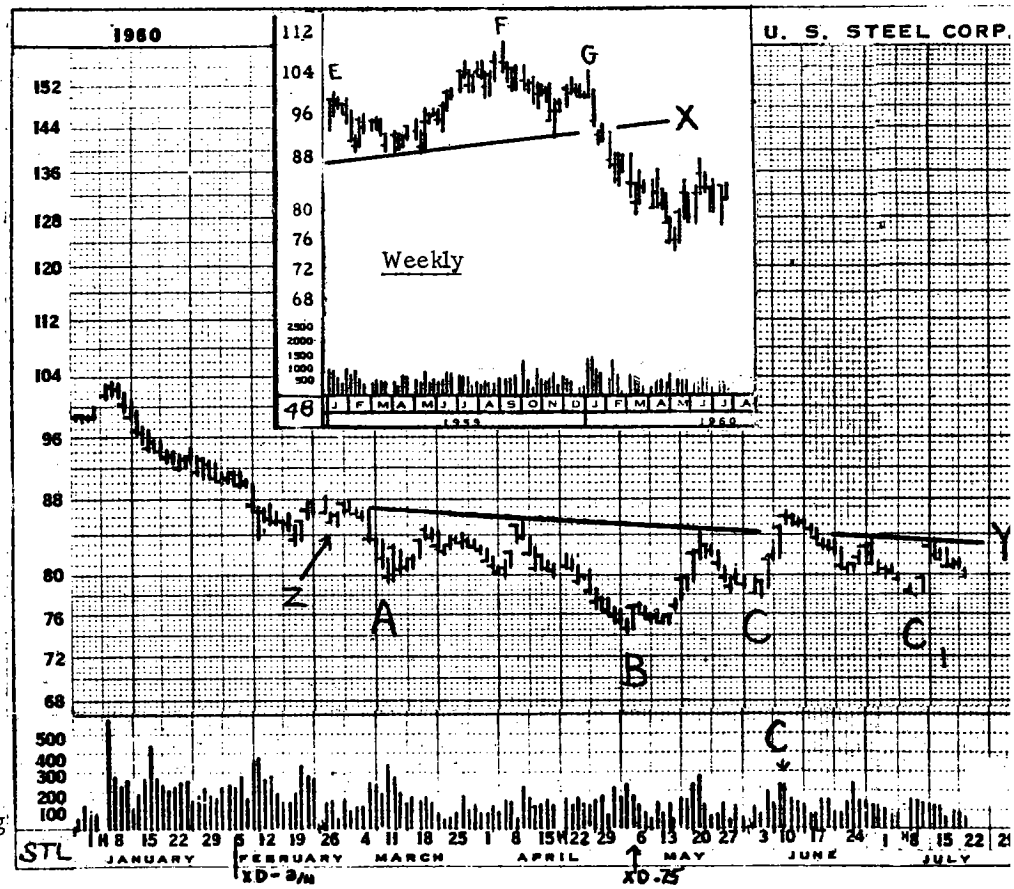
A former subscriber writes, "A few months ago I subscribed to another service -- one which was in keeping with my own bullish wishes. This resulted in my purchasing 100 shares of Kaiser Aluminum at 48 and 100 shares of Universal Match at 69. Last week I sold them both for a net loss of $1700.00 (and this after cleaning out near the top)! I have finally learned my lesson and am through trying to beat the trend of the Averages. Enclosed is my renewal for another year of Dow's Theory". This correspondence is not presented as an advertisement for Dow's Theory; I have included it because I wish to suggest that for every "scalper" who beats the trend there are a few dozen who lose their money. Perhaps some day an honest man will write a book entitled, "How I Avoided Losing My Hard-Earned Capital in the Stock Market". But I suppose such a title would not be considered a "success story" until somewhere near the bottom of a bear market.

"AS STEEL GOES so goes the nation", runs the old adage. Because steel is used in a majority of all manufactured goods, a case can be made for the old adage's still holding true. The accompanying chart (page 4) shows the price movements of U. S. Steel, the acknowledged leader in this key industrial group.

On the small insert at the top of the chart we see the weekly movements of Steel. A great "head-and-shoulders" top was formed during late 1958 and 1959, and this structure was so huge that it took a year and a half to complete. The left shoulder is marked E on the chart, the head F and the right shoulder G. The "neckline" or support level is marked X, and it is above this level that the stock was distributed on the three major rallies, E, F and G. When the neckline was cracked at 88 in January, 1960, U. S. Steel had officially topped, as far as chartists were concerned.

On the Daily chart we see the breakthrough at 88. A "pullback" to the neckline occurred in late February, but here volume dropped drastically, and the stock was in perfect position for shorting. The stock then continued down to its May low of 74. 1/8.

From March, 1960, through June, Steel attempted to form a "head-and-shoulders bottom" or reversal to the upside. This formation is exactly the opposite of the head-and-shoulders top. The left shoulder is marked A, the head B and the right shoulder C. But on the June rise from the right shoulder (C) volume did not expand impressively (a prerequisite) on the upside penetration of the neckline (neckline is marked Y). When the rally did not follow through, Steel retreated into the right shoulder area (C 1).



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Although technically Steel must be classified as being in an uptrend (the last confirmed trend was up), a move to 77 would mean that it had again turned bearish. Steel's questionable "strength" and the possible false breakout illustrates one of the hazards which buyers face during a bear market.

Often one or two important stocks in a group will reverse to the downside, thus giving advance notice of general group weakness. On July 20 Republic Steel cracked its secondary support at 60, which again puts it in line for new short commitments (RS was first suggested as a short in Letter 97 - price then was 66). Watch the following steels for downside reversals (figures in parentheses are closing prices at which they may be shorted) U. S. Steel (77), Jones & Laughlin (66), Bethlehem (43). Latest short figures show a drop in short interest on all major steels, which is bearish.

NOTES. (1) The June 15 to July 15 short interest figures show a drop of 197 thousand, which reduces the total short interest to 3.05 million shares. The short interest ratio thus rose slightly from .91 to .97. The latest drop in the actual short interest plus the fact that the short interest ratio has now held under 1.0 for two months must be taken as technical weakness.

(2) The advance-decline ratio is at its low for 1959-60.

(3) Barron's new revised index of low-priced stocks touched a new low last week.

(4) Barron's Business Index hit another low of 85.2 last week, still below the worst point of the 1959 steel strike.

STOCKS. The following are short candidates (M means sell at market, figure in parentheses means sell if stock closes at or below that figure). Aluminium Ltd. (M), Daystron (M), Minneapolis Moline (20 1/2), St. Regis Paper (M), Scott Paper (84), Spiegel (30), Kaiser Aluminum (M), General Motors (42 3/4).

(Written Thursday, July 21st - 12 P.M.)